

## ANALYSIS OF ORIGINAL BILL

Author: Rainey et. Al. Analyst: Marion Mann DeJong Bill Number: SB 1478

Related Bills: See Legislative History Telephone: (916) 845-6979 Introduced Date: 02/03/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Shift Burden Of Proof/Tax Collecting State Agencies

### SUMMARY

This bill would add a new provision to the Government Code to shift the burden of proof from taxpayers to the agencies collecting taxes in any court or administrative tax proceeding under certain conditions.

### EFFECTIVE DATE

This bill would be operative January 1, 1999, and would apply to legal actions that are filed in connection with tax disputes that arise on or after that date.

### LEGISLATIVE HISTORY

AB 1488, AB 1631, AB 1633, SB 1166, SB 1425.

### BACKGROUND

H.R. 2676, which is known as the "Internal Revenue Service Restructuring and Reform Act of 1997," contains 31 provisions under the title Taxpayer Protection and Rights. One such provision would shift the burden of proof in court proceedings from the taxpayer to the Internal Revenue Service (IRS). Under the proposed federal bill, the burden of proof shift would not apply to partnerships, corporations or trusts whose net worth is more than \$7 million. In addition, the burden of proof shift would apply only if the taxpayer has fully cooperated with the IRS, "including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested." The provision would apply to court proceedings arising in connection with examinations commencing after the date of the enactment of the Act.

This proposed legislation passed the House of Representatives on November 5, 1997. The Senate is expected to hold hearings early this year and produce its own version of IRS restructuring legislation by spring.

### DEPARTMENTS THAT MAY BE AFFECTED:

\_\_\_ STATE MANDATE

\_\_\_ GOVERNOR'S APPOINTMENT

#### Board Position:

\_\_\_ S \_\_\_ O  
\_\_\_ SA \_\_\_ OUA  
\_\_\_ N \_\_\_ NP  
\_\_\_ NA \_\_\_ NAR  
\_\_\_X\_\_\_ PENDING

#### Agency Secretary Position:

\_\_\_ S \_\_\_ O  
\_\_\_ SA \_\_\_ OUA  
\_\_\_ N \_\_\_ NP  
\_\_\_ NA \_\_\_ NAR  
DEFER TO \_\_\_\_\_

#### GOVERNOR'S OFFICE USE

Position Approved \_\_\_  
Position Disapproved \_\_\_  
Position Noted \_\_\_

Department Director

Gerald H. Goldberg

3/2/98

Agency Secretary

Date

By:

Date:

#### SPECIFIC FINDINGS

**Under current federal law**, taxpayers may be requested by the IRS to substantiate items reflected on their federal income tax returns. The IRS may issue a deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return or third party information returns (W-2s, 1099s, etc.). If collection is determined by IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable.

Taxpayers may protest deficiency assessments or jeopardy assessments to the IRS. In the event the IRS denies the protest, under the federal appeals system, the taxpayer may either: (1) appeal the assessment to the Tax Court (which has a small claims division for amounts of \$10,000 or less), or (2) pay the assessment and file a claim for refund with the IRS. Once the IRS denies the claim, the taxpayer may file suit for refund in an U.S. District Court or the U.S. Court of Claims.

In these reviews, a rebuttable presumption exists that the IRS's determination of tax liability is correct. Taxpayers have the burden of proving that the IRS's action was incorrect and establishing the merits of their claims by a preponderance of the evidence. This review is an independent judicial review by a trial court upon evidence submitted by the parties. Both the taxpayer and the IRS can bring actions in appellate courts to appeal final adverse determinations, except small claims division determinations, which are binding.

**Under current Personal Income Tax Law (PITL) and Bank and Corporation Tax Law (BCTL)**, taxpayers may be requested by the Franchise Tax Board (FTB) to furnish substantiation of the items reflected on their income tax returns. The FTB may issue a proposed deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return, third-party information returns (W-2s, 1099s, etc.), or information FTB receives from IRS. In the rare instance that collection is determined by FTB to be in jeopardy, a jeopardy assessment is issued whereby the amount of the deficiency is immediately due and payable.

If the taxpayer disputes an assessment, the taxpayer may (1) protest the proposed deficiency assessment or jeopardy assessment by filing a written "protest" with the FTB, or (2) pay the assessment and file a claim for refund (in which case the taxpayer may proceed to the Board of Equalization [BOE] or Superior Court if the claim is denied or no action is taken on the claim within six months).

The taxpayer's forum for appealing an adverse FTB action is the BOE. The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the independent review by BOE, there is a rebuttable presumption that the FTB action was correct. Hence, taxpayers have the burden of producing evidence to show that the FTB's action was incorrect and establishing the merits of their position by a preponderance of the evidence.

In the event of a final adverse BOE decision the taxpayer's recourse is to pay the amount due and bring an action for refund against the state in Superior Court. With residency matters payment is not required. In litigation, as with appeals, there is a rebuttable presumption that the FTB action was correct. In addition, a taxpayer in a suit for refund is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of proving that the FTB's action was incorrect and establishing the merits of their claims by a preponderance of the evidence.

**This bill** would shift the burden of proof from taxpayers to the agencies collecting taxes in any court or administrative tax proceeding if the taxpayer (1) asserts a reasonable dispute with respect to an issue or issues and (2) fully cooperates with the state agency with respect to those issues. Fully cooperates includes providing, within a reasonable amount of time, access to or inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the state agency.

For purposes of **this bill**, state agency includes FTB, BOE, the Employment Development Department (EDD) and any other agency that collects taxes.

**This bill** would not be construed to supersede or limit the application of any legal requirement to substantiate any item.

#### Policy Considerations

The provisions of this bill would raise the following policy considerations.

- Shifting the burden of proof in any court or administrative tax proceeding would impact every assessment made by the department and could result in reduced compliance and more intrusive audits.

Taxpayers may be more likely to take aggressive positions on returns and contest audit results. Audits would have to be more thorough to obtain the proof necessary to sustain audit findings.

Further, filing enforcement efforts may be impaired since deficiency assessments issued to taxpayers that do not file returns are sometimes based on limited income information.

- On the other hand, for many taxpayers the income tax system is their only contact with government and the large bureaucracy frightens them. Thus, they may not protest or appeal audit findings even if they believe them incorrect. Proponents believe that this provision would create a better balance between government and taxpayers.
- Generally in civil cases the burden of proof is on the plaintiff, the party seeking corrective action. The taxpayer is the plaintiff in all California Superior Court actions. In addition, for tax cases the taxpayer has control of the records and documents necessary to ascertain the taxpayer's tax liability.
- The burden of proof provision of this bill does not conform to the proposed federal provision, but is instead much broader.

- Currently, the taxpayer is asked to substantiate the amounts reported on the return, and deductions are considered to be a matter of legislative grace. The Internal Revenue Code (IRC) and R&TC have few statutes that specifically require substantiation; the requirement to substantiate an item rests mainly in case law regarding the burden of proof.
- Unlike Tax Court or other federal courts, the administrative review of tax cases by the BOE is currently performed in an informal environment without extensive evidentiary rules. This is designed to provide a "user friendly" forum to taxpayers contesting their assessment. A shift in the burden of proof would necessitate some formalization of the evidentiary elements of these proceedings. Accordingly, this bill may lead to a "greater balance" between the parties, but may lead to a more formalized hearing process with a greater need for professional representation for taxpayers.

#### Implementation Considerations

The provisions of this bill would raise the following implementation considerations. Department staff is available to help the author resolve these concerns.

- The bill is internally inconsistent. Subdivision (a) says "notwithstanding any other provision of law," but paragraph (1) of subdivision (c) says "no provision of the section shall be construed to supersede or limit the application of a legal requirement for substantiation of any item." Subdivision (a) also says that the state agency would have the burden of proof in any "court or administrative tax proceeding," but in paragraph (2) of subdivision (c) says the bill would apply only to "legal actions" filed in connection with tax disputes that arise on or after the operative date of the bill.
- The terms "reasonable dispute," "cooperates fully," "administrative tax proceeding," "tax disputes" and "legal actions" are not defined. Undefined terms can lead to disputes between taxpayers and the department. It is unclear whether a taxpayer that does not maintain records or destroys the records would be fully cooperating. Further, unless administrative tax proceeding is defined, it is unclear if the burden of proof would shift to FTB at some internal department administrative proceeding or at the BOE (which is the external administrative proceeding).
- In refund cases or in protest cases where the taxpayer asserts a new issue supporting their position, the department may not have had an opportunity to obtain supporting documents from the taxpayer. It is unclear whether the audit staff would be required to seek additional supporting data for all cases to protect the state's interest in the event the case is protested or appealed.

- One significant department workload is assessments based upon federal Revenue Agent Reports (changes made by the IRS to gross income or deductions reported on the federal return). Currently, such adjustments are presumed to be correct. It is unclear whether this provision would remove that presumption and require the department to prove that the changes made by the IRS to the federal return are correct.
- Currently, FTB generally retains taxpayer records for a period of three to four years and then destroys them, as authorized under R&TC Section 19530. Shifting the burden of proof to the department may require longer retention of records and increased costs for storage.
- The potential of a shift in the burden of proof would require FTB to engage in more extensive evidentiary gathering activities. This may require personnel additions to the audit and legal staff.
- Under certain conditions, this bill would shift the burden of proof to FTB in ascertaining the "tax liability" of a taxpayer. It is unclear whether the burden of proof would be shifted to the FTB on issues related to penalty and interest. This ambiguity derives from the fact that current law is unclear as to whether penalty and interest are an addition to, and therefore part of, the tax or something separate and apart from the tax.

## FISCAL IMPACT

### Departmental Costs

The departmental costs associated with this bill are unknown. The costs could increase, however, to the extent that additional supporting evidence would be required on all cases to support the state's position on any cases that are contested.

### Tax Revenue Estimate

This bill would result in unknown, but potentially significant, revenue losses.

### Tax Revenue Discussion

The revenue losses for this bill would be determined by those assessments that may be revised due to incomplete documentation to support the assessment and revenue lost from possible negative effects on voluntary compliance.

Revenue losses in any given year are unknown. It is not possible to determine the number of cases in which the outcome would be changed because of the shift in the burden of proof. It is not clear how the courts would define "cooperating taxpayer." Currently, the Department has approximately \$1.5 billion of tax assessments in protest status for both PIT and B&CT programs.

The Joint Committee on Taxation in its revenue estimate of H.R. 2676 estimated that shifting the burden of proof would result in a cumulative revenue loss of \$795 million for fiscal years 1998 to 2002. It has been expressed at the federal level that a negative revenue impact may result from reduced self-assessed reporting, which could have an effect on departmental audit programs. Because the language of this bill does not conform to the federal proposed legislation, it is not possible to use the federal revenue impact to measure the impact from this bill.

BOARD POSITION

Pending.